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Creditors' Considerations under Chapters 11 and 12 of the Bankruptcy Code

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CREDITORS' CONSIDERATIONS UNDER CHAPTERS 11 AND 12 OF THE BANKRUPTCY CODE

Jo Mickelson*

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INTRODUCTION

The federal Bankruptcy Code¹ attempts to protect a debtor² by pro-

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1. 11 U.S.C. §§ 101 to 1330 (1982 & Supp. V 1987).

2. A person, "except a stockbroker or a commodity broker, . . . may be a debtor under chapter 11 . . ." which allows for collection, distribution, and liquidation of the bankrupt estate. 11 U.S.C. § 109(d) (1982 & Supp. IV 1986). Chapter 9 of the Bankruptcy Code provides the exclusive remedy for municipalities. See 11 U.S.C. §§ 109(c), 301 (1982). Chapter 11 applies to corporate and individual business reorganizations. Only a family farmer under 11 U.S.C. § 101(18) (1982 & Supp. IV 1986), with "regular annual [farming] income . . ." may qualify as a debtor under Chapter 12. See 11 U.S.C. § 109(f) (1982 & Supp. IV 1986). Only individuals meeting the income and debt limitations of 11 U.S.C. § 109(e) (1982) may

viding a respite from creditors and an opportunity for a fresh start free from accumulated and burdensome debt. A debtor's bankruptcy, therefore, often drastically affects creditors. This article examines creditors' rights and remedies under Chapters 11³ and 12⁴ of the Bankruptcy Code. Chapter 11 provides for corporate or individual business reorganization. Chapter 12 provides for family-farm reorganization. The effect and scope of the automatic stay, confirmation of a debtor's plan, postconfirmation modification, and hardship discharges affect creditors under both chapters. This article is intended as a practical guide, presenting potential problems facing the creditor and the creditor's counsel, and offering possible solutions.

I. THE AUTOMATIC STAY

The Code's automatic stay provision⁵ presents numerous and varied ramifications for creditors. Counsel should consider the following possibilities before recommending a particular action to a creditor.

A. Immediate Effect of the Stay

Upon the filing of a petition in bankruptcy, section 362 of Chapter 11 provides for an automatic stay of litigation, lien enforcement, and other actions, judicial or otherwise, which would affect or interfere with property of the bankruptcy estate, property of the debtor, or property in the custody of the estate.⁶ The stay of an action against property of the estate continues until the particular property which interests a creditor leaves the estate.⁷ The stay against other acts, such as actions to recover money owed prior to bankruptcy, continues until final disposition of the case.⁸ Any action taken in violation of the stay is void.⁹ The bankruptcy court may punish willful violation of the stay with contempt sanctions and may award compensatory damages, costs, attorneys' fees, and, in appropriate cases, punitive damages.¹⁰

use Chapter 13, which allows the debtor to retain assets, as opposed to a Chapter 7 liquidation.

3. 11 U.S.C. §§ 1101 to 1174 (1982 & Supp. V 1987).

4. 12 U.S.C. §§ 1201 to 1231 (1982).

5. 11 U.S.C. § 362 (1982 & Supp. V 1987).

6. *Id.*; see also *Ford Motor Credit Co. v. Tri-State Well Service*, 6 Mont. Bankr. Rep. 136, 138 (Bankr. D. Mont. Aug. 22, 1988). The filing of a petition will not operate as a stay under certain circumstances. See 11 U.S.C. § 362(b) (1982 & Supp. IV 1986). Estate property includes property in which the debtor has either a legal or equitable interest. *Wendy's of Montana, Inc. v. Eggebrecht (In re Wendy's of Montana)*, 4 Mont. Bankr. Rep. 247, 250 (Bankr. D. Mont. Apr. 20, 1987).

7. 11 U.S.C. § 362(c)(1) (1982 & Supp. IV 1986).

8. 11 U.S.C. § 362(c)(2) (1982 & Supp. IV 1986). Also, a creditor's failure to receive formal notice of the stay does not alter its effectiveness. *In re Stucka*, 77 Bankr. 777 (Bankr. C.D. Cal. 1987).

9. *In re Skinner*, 90 Bankr. 470 (D. Utah 1988); *In re A.I.A. Indust., Inc.*, 75 Bankr. 1013 (Bankr. E.D. Pa. 1987).

10. See 11 U.S.C. § 362(h) (1982 & Supp. IV 1986); *Fidelity Mortgage Investors v.* <https://scholarworks.umt.edu/mlr/vol50/iss2/6>

B. *The Stay and Nondebtors*

Generally, only the debtor and the debtor's property or estate benefit from the section 362 stay,¹¹ as this stay does not favor any entity other than the debtor except in the most exigent circumstances.¹² As the Bankruptcy Court for the District of Montana stated this rule: "In the absence of special circumstances, stays pursuant to § 362(a) . . . do not include non-bankrupt codefendants."¹³ Courts have found special circumstances when continued litigation would frustrate reorganization efforts.¹⁴ Also such circumstances obtain when the debtor and guarantor are so closely related that a judgment against the creditor is, in effect, a judgment against the debtor.¹⁵ Nonetheless, courts have seldom stayed actions against a codebtor, such as a guarantor or general partner.¹⁶

Although Chapter 12, covering farm and ranch debtors, also provides a stay on actions against codebtors on consumer debts,¹⁷ it does not apply to debts incurred for operational costs.¹⁸ Under both Chapters 11 and 12, to the extent a reorganization plan does not provide for payment of a claim, the stay does not prevent creditors' suits against that debtor's coobligors and guarantors.¹⁹ Under those circumstances, the action for payment may as well proceed. As the Ninth Circuit Bankruptcy Appellate Panel stated, "It would make little sense to defer such relief when it is known that the creditor will never receive the unprovided-for amount, under the plan, from the debtor."²⁰

C. *An Alternative to the Stay: Injunction*

Because in most circumstances the automatic stay applies only to the debtor and its property, the trustee or debtor in possession may attempt to use the relief provided by section 105(a) of Title 11 of the Bankruptcy Code, as a secondary means of halting a creditor's action. Under this section, a court may enjoin claims against a debtor's codefendants, guarantors and partners. Courts have consistently held that this injunctive relief

Camelia Builders, Inc., 550 F.2d 47 (2d Cir. 1976), *cert. denied*, 429 U.S. 1093 (1977).

11. *Ford Motor Credit Co.*, 6 Mont. Bankr. Rep. at 136-40.

12. See *In re Casgul of Nevada, Inc.*, 22 Bankr. 65, 66 (Bankr. 9th Cir. 1982). If extreme circumstances exist and the movant can meet the burden imposed by 11 U.S.C. § 105(a) (1982 & Supp. V 1987), the stay may be granted in favor of the other entity.

13. *Federal Land Bank of Spokane v. Stiles*, 5 Mont. Bankr. Rep. 363, 368 (Bankr. D. Mont. Feb. 29, 1988) (*quoting* *Ingersoll-Rand Fin. Corp. v. Miller Mining Co.*, 817 F.2d 1424, 1427 (9th Cir. 1987)). See also *Credit Alliance Corp. v. Williams*, 851 F.2d 119, 121 (4th Cir. 1988).

14. See, e.g., *A.H. Robins Co. v. Piccinin*, 788 F.2d 994, 1009-10 (4th Cir. 1986).

15. See *Credit Alliance Corp.*, 851 F.2d at 121.

16. See, e.g., *Ford Motor Credit Co.*, 6 Mont. Bankr. Rep. at 136; *In re Kalispell Feed and Grain Supply, Inc.*, 55 Bankr. 627 (Bankr. D. Mont. 1985).

17. 11 U.S.C. § 1201 (1982 & Supp. V 1987).

18. 11 U.S.C. § 101(7) (1982) defines consumer debt as "debt incurred by an individual primarily for a personal, family, or household purpose."

19. *In re Robinson Ranch, Inc.*, 75 Bankr. 606, 611 (Bankr. D. Mont. 1987).

20. *In re Jacobsen*, 20 Bankr. 648, 650 (Bankr. 9th Cir. 1982).

constitutes an extraordinary remedy, placing the burden of proof on the debtor-movant to establish the traditional showing of entitlement to injunctive relief.²¹ As the Bankruptcy Court for the District of Montana has noted, the party moving for a preliminary injunction must show:

1. [A] substantial likelihood that the movant will [ultimately] prevail on the merits;
2. Irreparable harm to the movant bankrupt estate in the absence of injunctive relief;
3. Proof that the threatened injury to the movant outweighs whatever damage the proposed injunction may cause [the opposing party]; and
4. [T]hat the injunction [, if issued,] will not be adverse to the public interest.²²

A party can generally fulfill this burden only in extraordinary circumstances. Thus, actions against the debtor's or estate's property are stayed, while actions against comakers, codefendants and guarantors usually are not stayed.

D. *The Stay's Effect on Lien Perfection*

The Bankruptcy Code provides that any bankruptcy filing does not stay "any act to perfect an interest in property to the extent that the trustee's rights and powers are subject to such perfection under section 546(b)" ²³ Section 546(b), in turn, subjects the rights and powers of a trustee to avoid liens or obligations "to any generally applicable law that permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of such perfection."²⁴ In other words, the Bankruptcy Code allows the creditor to *perfect* interests in property acquired prior to the bankruptcy filing, even while staying *enforcement* of any such interests.

A creditor, therefore, need not move for relief from the automatic stay in order to file a continuation statement perpetuating the effectiveness of a financing statement filed before the bankruptcy petition.²⁵ Nor does a stay require a creditor to obtain relief before renewing a notice of

21. See, e.g., *In re Costa and Head Land Co.*, 68 Bankr. 296, 299 (N.D. Ala. 1986); *In re Kalispell Feed and Grain Supply, Inc.*, 55 Bankr. at 629-30; *In re Keyco, Inc.*, 49 Bankr. 507, 509-10 (Bankr. E.D. N.Y. 1985).

22. *Kalispell Feed and Grain*, 55 Bankr. at 629 (citing *Regents of Univ. of California v. ABC, Inc.*, 747 F.2d 511, 515 (9th Cir. 1984)).

23. 11 U.S.C. § 362(b)(3) (1982).

24. 11 U.S.C. § 546(b) (1982).

25. See, e.g., *Craft v. Fisk Assoc. (In re Millerlee Corp.)*, 70 Bankr. 780 (Bankr. S.D.N.Y. 1987), *Poloron Prods. of Bloomsburg, Inc. v. Sands (In re Poloron Prods. of Bloomsburg, Inc.)*, 76 Bankr. 383 (Bankr. M.D. Pa. 1987), 2 COLLIER ON BANKRUPTCY ¶ 362.05[3] (L. King ed. 15th ed. 1979). As of January 1, 1983, a creditor must renew its notice of security agreement and continuation statement every five years. MONT. CODE ANN. § 81-8-301(2) (1987).

security agreement covering livestock.²⁶ The Uniform Commercial Code Bureau of the Montana Office of the Secretary of State, however, has advised that creditors should indicate on continuation statements filed in bankruptcy cases when the insolvency was filed and its status.²⁷

Montana law also maintains a creditor's protected status during an intervening bankruptcy. "If a security interest perfected by filing exists at the time insolvency proceedings are commenced by or against the debtor, the security interest remains perfected until termination of the insolvency proceedings and thereafter for a period of 60 days or until expiration of the 5-year period, whichever occurs later."²⁸ The Seventh Circuit Court of Appeals has held that an identical provision in the Indiana Commercial Code prevents a properly filed financing statement from lapsing on the expiration of the original financing statement during an intervening bankruptcy.²⁹ However, another bankruptcy court may not interpret Montana's statute in the same way. Therefore, a creditor should ensure its continued protected status by filing a continuation statement or by renewing the notice of security agreement.

E. The Stay and the "One Action Rule"

The automatic stay may also affect proceedings to recover real or personal property. Montana's one action rule governs foreclosure of real estate mortgages.³⁰ If the mortgagor defaults, the one action rule requires a creditor to include a prayer for any deficiency in the foreclosure action.³¹ Moreover, the rule estops the creditor from first suing on the note and then later filing a foreclosure action.³²

In the bankruptcy context, a debtor, codebtor, or guarantor can plead the one action rule as an affirmative defense when a creditor brings suit on the note and the mortgage, and subsequently tries to file a deficiency action.³³ This scenario is most likely to occur when the creditor has failed to join a bankrupt debtor due to the Bankruptcy Code's automatic stay provision.

On the other hand, a bankruptcy court should not interpret a creditor's filing of a proof of claim³⁴ as an "action" within the meaning of

26. See, e.g., *In re Millerlee Corp.*, 70 Bankr. 780 (Bankr. S.D.N.Y. 1987).

27. Telephone interview with Uniform Commercial Code Bureau (Montana Secretary of State) (Dec. 1, 1988).

28. MONT. CODE ANN. § 30-9-403(2) (1987).

29. *In re Chaseley's Foods, Inc.*, 726 F.2d 303, 308 (7th Cir. 1983) (quoting *Isaacs v. Hobbs Tie and Timber Co.*, 282 U.S. 734, 738 (1931)). See also, *Lockhart v. Garden City Bank and Trust Co.*, 116 F.2d 658 (2d Cir. 1940).

30. MONT. CODE ANN. § 71-1-222 (1987).

31. *Barth v. Ely*, 85 Mont. 310, 320, 278 P. 1002, 1006 (1929); G. NELSON & D. WHITMAN, *REAL ESTATE FINANCE LAW* § 8.2 (2nd ed. 1985).

32. *Coburn v. Coburn*, 89 Mont. 386, 388, 298 P. 349, 350 (1931).

33. *Brophy v. Downey*, 26 Mont. 252, 256, 67 P. 312, 314 (1902).

34. A creditor may file a proof of its claim against the debtor with the bankruptcy court. 11 U.S.C. § 501 (1982 & Supp. IV 1986).

Montana's one action rule. Pertinent statutes define "action" for the purposes of the one action rule as "a special proceeding of a civil nature"³⁵ "prosecuted by one party against another for the enforcement or protection of a right"³⁶ In addition, the Bankruptcy Code defines a "claim" as a "right to payment."³⁷ When filing a claim in bankruptcy, a party is not engaged in a special proceeding or prosecution. Therefore, when a creditor has filed a suit on a note and a mortgage and the obligor subsequently files for bankruptcy, the creditor should be able to file a proof of claim and move for relief from the stay, naming the debtor as an indispensable party. The motion will probably succeed if it includes a specific statement that the creditor will not attempt enforcement of the judgment against the bankrupt debtor, thereby limiting the motion's scope.

A creditor must also be aware of the one action rule when both real and personal property secure the debtor's obligation. Montana's Commercial Code governs a creditor's self-help remedies regarding personal property,³⁸ and provides that if a secured party proceeds against the real and personal property in one action, then the one action rule governs the proceeding.³⁹ In Montana, resorting to self-help repossession of personal property while proceeding judicially against real property could prompt a successful affirmative defense based upon the one action rule.⁴⁰

A creditor holding an obligation secured by both real and personal property should therefore consider these alternatives: (1) resort to the Commercial Code's self-help remedies to repossess personal property and only then foreclose judicially upon the real property; (2) file an action foreclosing on all security, both real and personal; (3) restructure the obligation as two debts, one secured by personal property and the other secured by real property.⁴¹

II. CONFIRMATION

A. *Differences Between Chapters 11 and 12 upon Confirmation*

Creditors may still be hindered by the automatic stay even after a bankruptcy court confirms a reorganization plan.⁴² Confirmation of a

35. MONT. CODE ANN. § 25-1-102(2) (1987).

36. MONT. CODE ANN. § 27-1-103(2) (1987).

37. 11 U.S.C. § 101(4)(B) (1982).

38. MONT. CODE ANN. § 30-9-501(4) (1987).

39. *Id.*; MONT. CODE ANN. § 30-9-508 (1987).

40. MONT. CODE ANN. § 71-1-222 (1987). Montana adopted the one action rule from the California Code of Civil Procedure. The Montana Supreme Court has held that Montana has also adopted California's construction of that statute. *Barth*, 85 Mont. at 321, 278 P. at 1006. California courts have interpreted their one action rule to mean that a creditor must foreclose on all security in one action. *Pacific Valley Bank v. Schwenke*, 189 Cal. App. 3d 134, 146, 234 Cal. Rptr. 298, 305-06 (1987); *Walker v. Community Bank*, 10 Cal. 3d 729, 733, 518 P.2d 329, 331, 111 Cal. Rptr. 897, 899 (1974).

41. See Dietrich, *The Montana Judicial and Non-Judicial Foreclosure Sale: Analysis and Suggestions for Reform*, 49 MONT. L. REV. 285, 307 (1988).

42. The bankruptcy court approves the reorganization plan proposed by the debtor, <https://scholarworks.umt.edu/mlr/vol50/iss2/6>

debtor's plan has different effects depending on the type of bankruptcy filing. Under Chapter 11, confirmation of a reorganization plan vests all property of the estate in the debtor.⁴³ Subject to certain exceptions,⁴⁴ confirmation also discharges the debtor from all claims arising prior to the date of confirmation. Where confirmation does not discharge such debt and a Chapter 11 debtor defaults after confirmation of the plan, the creditor can immediately proceed with its state law remedies. The automatic stay is no longer in effect.⁴⁵

In Chapter 12 cases, on the other hand, confirmation does not discharge the debtor's obligations and the stay remains in effect until completion of all payments to unsecured creditors under the plan.⁴⁶ As a result, until the court discharges the Chapter 12 debtor or dismisses the case, a creditor must seek relief from the automatic stay to proceed with any state law remedies.

B. Effect of Confirmation and Discharge on Guarantors' Obligations

When a court discharges a bankrupt debtor's obligations, it does not discharge or eliminate the liabilities of codebtors or guarantors. Section 524(e) of the Bankruptcy Code states that "discharges of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt."⁴⁷ This section maintains a guarantor's liability for the prepetition obligation after release of the bankrupt principal through discharge in bankruptcy.

Unfortunately, Montana law appears to contradict the Bankruptcy Code. Montana's statutory guaranty law provides that "the obligation of a guarantor must be neither larger in amount nor in other respects more

provided that the debtor has complied with either 11 U.S.C. § 1129 (1982 & Supp. IV 1986) or 11 U.S.C. § 1225 (1982 & Supp. IV 1986).

43. Such property is free of all claims and interests, except as provided in the confirmation order or reorganization plan. 11 U.S.C. § 1141(b) and (c) (1982 & Supp. IV 1986).

44. Collier summarized exceptions to confirmation discharge as follows:

1. To the extent that the plan or order of confirmation provides for payment of a claim, such claim is not discharged.
2. Confirmation of the plan does not discharge an individual debtor from any debt excepted from discharge under Section 523.
3. Confirmation of a plan of liquidation does not discharge a debtor partnership or corporation which does not engage in business after confirmation of the plan.
4. The debtor will not be discharged if it executes after the date of entry of the order for relief a written waiver of discharge which is approved by the court.
5. If the creditor is not given notice of the case and (a) the creditor's claim is not scheduled or (b) if it is scheduled as disputed, contingent or unliquidated as to amount, such claim will not be discharged.

5 COLLIER ON BANKRUPTCY ¶ 1141.01 (L. King ed. 15th ed. 1979).

45. See *In re Timber Tracts, Inc.*, 70 Bankr. 773, 778 (Bankr. D. Mont. 1987); *In re Herron*, 60 Bankr. 82, 84 (Bankr. W.D. La. 1986); *In re R.C.E. Corp. (In re Ernst)*, 45 Bankr. 700, 702 (Bankr. D. Minn. 1985).

46. 11 U.S.C. § 1228(a) (1982 & Supp. IV 1986).

47. 11 U.S.C. § 524(e) (1982).

burdensome than that of the principal"⁴⁸ This provision appears to conflict with the Bankruptcy Code's provision for discharging a debtor while continuing to hold a guarantor liable. However, Montana's guaranty statutes also state that a "guarantor is not exonerated by the discharge of his principal by operation of law without the intervention or omission of the creditor."⁴⁹ Courts have consistently held that a bankruptcy discharge arises by operation of federal bankruptcy law, and not by contractual consent of the creditors.⁵⁰ Given the Bankruptcy Code provision and attendant case law interpretations, Montana's statutory provisions should have little effect on creditors in a bankruptcy proceeding. The Montana statute prohibiting a guarantor's assumption of a greater liability than the debtor should apply only in a contractual situation and not when the debtor is discharged by operation of law, as in bankruptcy.

Thus, when bankruptcy discharges a debtor's liability, it does not discharge a guarantor's liability. Even when the debtor's plan of reorganization reduces the debtor's obligation to a particular percentage of the total debt, the creditor should be able to seek the balance of the original, prepetition obligation from the guarantor.⁵¹ A Maryland bankruptcy court succinctly stated the policy argument for holding guarantors liable when debtors are discharged. "[C]ommon sense dictates that the guarantor remain fully liable even when the principal debtor seeks relief under the Bankruptcy Code. After all, what good is a guaranteed lease if the guarantor escapes liability when the debtor does?"⁵²

However, since guarantor liability has not been decided in Montana, a creditor should take three steps to better its case. First, a creditor should obtain individual guarantees whenever possible. Second, a creditor should object to a bankruptcy court's jurisdiction over, and alteration of, a guarantor's or codebtor's liability. Finally, a creditor should seek immediate enforcement of the guarantor's obligation. These actions will place the burden on the guarantor to prove that its obligation to the creditor has been reduced.

48. MONT. CODE ANN. § 28-11-201 (1987).

49. MONT. CODE ANN. § 28-11-214 (1987).

50. *Union Carbide Corp. v. Newboles*, 686 F.2d 593, 595 (7th Cir. 1982); *Bel-Ken Assoc. v. Clark*, 83 Bankr. 357, 358-59 (D. Md. 1988); *Beconta, Inc. v. Schneider*, 41 Bankr. 878, 879 (E.D. Mich. 1984).

51. See, e.g., *Underhill v. Royal*, 769 F.2d 1426, 1432 (9th Cir. 1985) (bankruptcy court does not have power to discharge liabilities of non-debtor); *R.I.D.C. Industr. Dev. Fund v. Snyder*, 539 F.2d 487 (5th Cir. 1976), *cert. denied*, 429 U.S. 1905 (1977) ("bankruptcy court can affect only the relationships of debtor and creditor [and] has no power to affect the obligations of guarantor" 539 F.2d at 490, n.3); *Bel-Ken Assoc.*, 83 Bankr. at 358. *But see, In re Sanders*, 81 Bankr. 496, 498-500 (Bankr. W.D. Ark. 1987) (because creditor did not object to the bankruptcy court's jurisdiction over guarantor nor to the confirmation of the plan, the *res judicata* doctrine precluded enforcement of the guaranty).

52. *Bel-Ken Assoc.*, 83 Bankr. at 359.

C. *Effect of Confirmation on Existing Judgments*

A creditor can protect the priority of its judgment lien in a confirmed plan of reorganization. Under the "merger doctrine," the obligations evidenced by a promissory note and mortgage merge into the final judgment.⁵³ A judgment is a lien⁵⁴ on the judgment debtor's real property owned at the time of judgment or acquired before the lien expires.⁵⁵ The lien remains effective for six years after docketing.⁵⁶ During this time the lien holder may request that the sheriff execute on the lien.⁵⁷

To protect the priority of its judgment lien, therefore, a creditor should assure that the confirmation order specifies that the creditor may apply to a court having jurisdiction for an extension of time during which the creditor may execute on the lien. The stipulation extending the statute of limitations should itself specify that the secured creditor retains its judgment lien priority position until the debtor makes full payment. The creditor should then request that the bankruptcy court specifically mention this stipulation in its order approving the reorganization. In addition, prior to the expiration of the six year period,⁵⁸ the creditor should move the state court for an order extending the lien until the debtor makes full payment.

III. STRATEGIES IN ANTICIPATION OF POSTCONFIRMATION DEFAULT

While negotiating settlement terms before confirmation, the creditor should structure the agreement to anticipate the negative impact of the debtor's possible default under a confirmed plan. The creditor can anticipate at least two issues. First, a bankruptcy court may restructure the obligation, confirm the plan and then dismiss the case entirely. This scenario leaves open the question of which obligation the creditor will subse-

53. *Toole v. Weirick*, 39 Mont. 359, 365, 102 P. 590, 592 (1909).

54. A judgment is also grounds for a cause of action. *Lindsay Great Falls Co. v. McKinney Motor Co.*, 79 Mont. 136, 143, 255 P. 25, 28 (1927). An action on a judgement must be commenced within ten years. MONT. CODE ANN. § 27-2-201(1) (1987). The remedy of execution is cumulative and does not impair the right of action on a judgment. *Id.*; *Montana v. Hart Refineries*, 109 Mont. 140, 144, 92 P.2d 766, 771 (1939).

55. MONT. CODE ANN. § 25-9-301(2) (1987).

56. In actuality, the lien remains effective so long as the creditor can bring an action on the underlying obligation. MONT. CODE ANN. § 71-3-122 (1987). The statute of limitations for judgments is 10 years. MONT. CODE ANN. § 27-2-201(1) (1987). However, Montana allows a sheriff to execute on the lien only during the six years after docketing. MONT. CODE ANN. § 25-9-301(2) (1987). During the remaining four years, the judgment holder must move the court to extend the six year period before obtaining a writ of execution. MONT. CODE ANN. § 25-13-102 (1987).

57. MONT. CODE ANN. §§ 25-9-301(2), 25-13-101 (1987). The court may extend this six year period upon motion or judgment. MONT. CODE ANN. § 25-13-102 (1987). *First National Bank of Ekalaka v. Hereford*, — Mont. —, —, 731 P.2d 1323, 1325 (1987) (upholding a lower court's granting of leave to execute after the six year period). Also, acknowledgment of the judgment may toll the statute of limitations for execution. *Dodd v. Simon*, 113 Mont. 536, 543, 129 P.2d 224, 228 (1942).

58. *Hereford*, — Mont. at —, 731 P.2d at 1325 (1987).

quently be entitled to enforce in state court, the obligation as restructured under the plan or the prepetition obligation. Second, if dismissal is not an appropriate remedy upon default, the issue arises regarding which obligation the creditor is entitled to enforce in state court, should the bankruptcy court grant its motion for relief from the stay.

A. *Postconfirmation Dismissal*

Dismissal is an appropriate remedy in a postconfirmation setting when cause supporting the motion exists.⁵⁹ Postconfirmation cause includes the debtor's failure to make timely payments as required by the confirmed plan, the debtor's material default under the plan, revocation of the order of confirmation, termination of a confirmed plan due to a condition specified in the plan, or continuing diminution of the estate without a reasonable possibility of rehabilitation.⁶⁰ The movant must prove the material nature of the default.⁶¹ The decision to grant dismissal lies within the bankruptcy judge's discretion. The Bankruptcy Code makes dismissal wholly permissive: "On request of a party in interest, and after notice and a hearing, the court *may* dismiss a case under this chapter for cause"⁶²

Dismissal is not appropriate if the plan provides the creditor with alternative remedies upon the debtor's failure to make plan payments. For example, the plan may provide that upon default, the secured creditor may foreclose on its collateral with no resulting personal liability to the debtor. In such a case, the bankruptcy court will probably not grant a dismissal.⁶³

If circumstances beyond the debtor's control cause its default, or if the default is not material, the bankruptcy court may deny the motion to dismiss. A more lenient bankruptcy judge may even excuse lateness in payments which would ordinarily constitute a material default.⁶⁴ A court may also grant the motion to dismiss, but allow the debtor to cure the postconfirmation default within a certain period.⁶⁵ When faced with a motion to dismiss a Chapter 11 case, the court may also convert the case to a Chapter 7 liquidation rather than dismiss it⁶⁶ if conversion is in the

59. 11 U.S.C. §§ 1112(b), 1208(c)(1)-(9) (1982 & Supp. V 1987).

60. *Id.*

61. *Cf. In re Midkiff*, 85 Bankr. 467, 470 (Bankr. S.D. Ohio 1988) (movant failed to establish the amount of a Chapter 13 debtor's default and court denied the motion to dismiss).

62. 11 U.S.C. § 1208 (1982 & Supp. V 1987) (emphasis added); *see also*, 11 U.S.C. § 1112(b) (1982 & Supp. V 1987); *In re Smith*, 85 Bankr. 729, 731 (E.D. Va. 1988).

63. *See In re Kelly*, 53 Bankr. 961, 963 (Bankr. W.D. Ky. 1985). The creditor cannot obtain a dismissal if it caused or contributed to the debtor's default. *In re 12th & N Joint Venture*, 63 Bankr. 36, 39 (Bankr. D. Col. 1986) (motion to dismiss denied because the creditor's failure to comply with contractual commitments partially caused the debtor's noncompliance).

64. *In re Smith*, 85 Bankr. 729, 731 (E.D. Va. 1988).

65. *In re Davis*, 64 Bankr. 358, 360 (Bankr. S.D.N.Y. 1986).

66. In a liquidation, unsecured creditors run the risk of receiving either only a minute

best interests of the creditors.⁶⁷ Under Chapter 12, only the debtor may move to convert the case, unless the creditor can show fraud.⁶⁸ Success on a motion to dismiss is, therefore, uncertain at best but worth attempting if the postconfirmation obligation otherwise binds the creditor.

Dismissal should have no effect on a coobligor's obligation, because, as explained above, bankruptcy does not alter that obligation and coobligors are jointly and severally liable.⁶⁹ A creditor's collection action against a coobligor is generally not stayed, and the creditor may seek the full amount of the obligation from the coobligor unless the Chapter 12 case involves a consumer debt. In a Chapter 11 case, however, because no provision exists staying actions against a coobligor, a creditor may seek full payment of an obligation from coobligors, regardless of the nature of the obligation.

B. Planning for Postconfirmation Dismissal

Under section 349 of the Bankruptcy Code, dismissal of a case reinstates receiverships, actions for receivership, avoided transfers, and avoided liens. Further, dismissal vacates certain orders and judgments or transfers, and it "revests the property of the estate in the entity in which such property was vested immediately before commencement of the case"⁷⁰ The legislative history of section 349 indicates that the purpose of the statute was to restore all property rights to their prebankruptcy position.⁷¹ To further congressional intent, the Ninth Circuit Court of Appeals has held that dismissal of a bankruptcy case effectively vacates a confirmed reorganization plan.⁷² Even so, to ensure its position, a creditor should specifically delineate in a stipulation the parties' rights on

portion of their unsecured claims or, more often, nothing at all. If the case is dismissed, the race to the courthouse is on again. The first creditor to file an action and obtain a judgment may realize more on dismissal than through liquidation. See MONT. CODE ANN. § 30-9-312 (1987).

67. 11 U.S.C. § 1112(b) (1982 & Supp. V 1987).

68. 11 U.S.C. § 1208(a), (d) (1982 & Supp. V 1987).

69. MONT. CODE ANN. § 28-1-302 (1987) (all joint obligations shall be taken as joint and several obligations).

70. 11 U.S.C. § 349(b)(3) (1982 & Supp. V 1987).

71. S. REP. No. 989, 95th Cong., 2d Sess. 48 (1978) *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 6294.

72. *In re Nash*, 765 F.2d 1410, 1413 (9th Cir. 1985). See also, *In re Case*, 27 Bankr. 844 (Bankr. D. S.D. 1983); but see, *In re Searles*, 70 Bankr. 266 (D. R.I. 1987) (considering whether § 349(b)(3) covers only property in the bankrupt estate at the time of dismissal or also property distributed prior to dismissal). The *Searles* court specified that its examination addressed only "property or property rights that [had] not passed out of the bankrupt estate." *Id.* at 270 (emphasis added). Ultimately the court held that § 349 covered property remaining in the estate at the time of dismissal. *Id.*

Legislative history also indicates that "[w]here there is a question over the scope of the subsection, the court will make the appropriate orders to protect rights acquired in reliance on the bankrupt estate." S. REP. No. 989, 95th Cong., 2d Sess. 49, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5835.

Montana federal courts have yet to rule on the scope of 11 U.S.C. § 349(b)(3).

dismissal.

Such precautions are necessary because a stipulation reducing an obligation could be viewed as a new promise to pay or a novation extinguishing the original obligation. If the restructuring agreement does not specify the parties' rights on dismissal or default, a court could limit the creditor to enforcement of the restructured obligation. Rather than leaving it open to interpretation, the creditor should specifically provide in the stipulation that the original obligation is not extinguished. Further, if appropriate, the stipulation should state that upon dismissal or default, the creditor may enforce either the original obligation, plus interest, costs, and attorneys' fees, or the restructured obligation, plus interest, costs, and attorneys' fees.

Strategically, because dismissal should vacate the confirmed plan of reorganization and reinstate the original prepetition obligation, a secured creditor should specify its rights upon default or dismissal. Then, upon postconfirmation default, a creditor should move to dismiss the bankruptcy case rather than immediately seeking redress in state court. This action should ensure that the prepetition obligation is reinstated, simply by function of either the dismissal's effect or the stipulation.

C. Alternatives to Dismissal

Several other alternatives to dismissal also exist. A creditor's counsel should carefully consider these alternatives as they provide flexibility in planning to protect against the obligor's postconfirmation default.

A negotiated provision for automatic lien reinstatement upon default presents one of the most important alternatives to dismissal. The confirmation order vests the debtor with all estate property free of liens, except as otherwise provided in the confirmed plan. Thus a creditor can use this exception to strengthen its collateral position in case of default. Lien reinstatement provisions in Chapter 11 default cases allow creditors to seek immediate enforcement of the prepetition obligation. In Chapter 12 cases, the creditor can move for stay relief, and if successful, sue on the prepetition obligation in state court.

Chapter 11 and 12 orders and plans frequently include another protective provision, the "drop dead" clause. This provision allows for automatic termination of the stay upon default. The creditor should combine this clause with an automatic reinstatement provision. This combination frees the creditor from the limitations inherent in a confirmed plan's restructured obligation.

Although a debtor's default can adversely affect a creditor's position in a confirmed plan, dismissal of the bankruptcy action may provide the creditor with some recourse. As well, the creditor can protect itself in planning for possible postconfirmation defaults by providing for specific lien reinstatement or the inclusion of a "drop dead" clause. Of course, the creditor can also fall back on basic equitable arguments. For example, a

creditor can request reconsideration of its claim.⁷³ Depending on the equities involved, the creditor may persuade the court that reinstatement of the prepetition obligation is appropriate.

IV. POSTCONFIRMATION MODIFICATION

Confirmation of a Chapter 11 or 12 plan does not necessarily ensure the debtor's performance. Debtors may face continued financial difficulties, threatening the plan's viability. However, a creditor may have standing to seek postconfirmation modification, providing it with continued protection. Moreover, a creditor may need to oppose a debtor's proposed postconfirmation modification to protect its claim. Creditors' counsel should therefore be familiar with the procedural and substantive aspects of postconfirmation modification.

A. *Standing to Move for Modification under Chapter 11*

Provided that standing is fulfilled, either the plan's proponent or the reorganized debtor may move for postconfirmation modification.⁷⁴ This standing requirement rarely presents a problem for the reorganized debtor, whose identity is obvious. Rather, most standing problems center around defining a "plan's proponent." The Bankruptcy Code does not define this term.

A Minnesota bankruptcy court recently considered this troublesome issue in *In re Charterhouse*.⁷⁵ That court held that a plan proponent, as contemplated by the Bankruptcy Code, "is a party in interest who negotiates, formulates, disseminates, makes disclosure in connection with, and seeks acceptances of, a reorganization plan."⁷⁶ Minor participation is not sufficient. As well, evaluation, formulation and drafting of the plan may not qualify a party as a "proponent" of a plan.⁷⁷ Rather, the party in interest must "engage in the initial process of plan formulation or preparation" ⁷⁸ Moreover, the party must be "responsible for . . . the process of presolicitation disclosure, plan dissemination, monitoring of acceptances, or presentation of evidence at the confirmation hearing."⁷⁹

73. Following default in a Chapter 12 case, the debtor should move for reconsideration in concert with a motion to lift the stay. See 11 U.S.C. § 502(j) (1982 & Supp. V 1987); BANKR. R. 3008 (1982 & Supp. IV 1986).

74. 11 U.S.C. § 1127(b) (1982 & Supp. V 1987); *Goodman v. Phillip R. Curtis Enters.*, 809 F.2d 228, 234 (4th Cir. 1987).

75. 84 Bankr. 147 (Bankr. D. Minn. 1988).

76. *Id.* at 151.

77. *Id.*

78. *Id.*; see also *In re Longardner & Assoc.*, 855 F.2d 455 (7th Cir. 1988).

79. 11 U.S.C. § 1127 (1982 & Supp. V 1987); see also H.R. Rep. No. 595, 95th Cong., 1st Sess. 411 (1977), reprinted in 1976 U.S. CODE & ADMIN. NEWS 6367; *In re Charterhouse Inc.*, 84 Bankr. 174, 151 (Bankr. D. Minn. 1988).

B. Grounds for Chapter 11 Modification

A bankruptcy court may allow modification any time after the plan's confirmation, so long as "substantial consummation" has not occurred. The Bankruptcy Code defines substantial consummation as the:

- (A) transfer of all or substantially all of the property proposed by the plan to be transferred;
- (B) assumption by the debtor or by the successor to the debtor under the plan of the business or management of all or substantially all of the property dealt with by the plan; and
- (C) commencement of distribution under the plan.⁸⁰

Substantial consummation requires compliance with all three elements.⁸¹

Although the Bankruptcy Code so defines "substantial consummation," courts still interpret the term. Two views currently compete regarding the term's common law definition. Under the first view, a court examines the percentage of payments made under a confirmed plan, measuring whether all or substantially all of the property has been transferred.⁸² For example, in *In re Heatron, Inc.*, the court stated that "[t]he word 'substantial' suggests more than halfway, more than a preponderance. When used with the word 'all' . . . there is a suggestion of completeness."⁸³ The court held that a fifty-three percent property transfer did not fulfill the "substantially all" requirement.⁸⁴

The second view rejects the *Heatron* analysis and holds that "substantial consummation" occurs when three conditions have been met:

- 1) the debtor's business is operational;
- 2) all or nearly all the debtor's property transfers have occurred at or near the plan's confirmation; and
- 3) the plan has commenced distributions of dividends to creditors, made over a period of time from the debtor's operating revenues.⁸⁵

This analysis distinguishes between transfers of the debtor's property at or near the time of confirmation and the distribution of dividends to creditors made over a period of time from the debtor's operating revenues. The most recent cases indicate that this analysis is better reasoned.⁸⁶

80. 11 U.S.C. § 1101(2) (1982).

81. *In re Gene Dunavant and Son Dairy*, 75 Bankr. 328, 332 (Bankr. M.D. Tenn. 1987).

82. See, e.g., *In re Heatron*, 34 Bankr. 526, 527 (Bankr. W.D. Mo. 1983); *Jorgensen v. Federal Land Bank of Spokane (In re Jorgensen)*, 66 Bankr. 104, 106-07 (Bankr. 9th Cir. 1986).

83. *In re Heatron*, 34 Bankr. at 529.

84. *Id.* at 527.

85. *U.S. v. Novak*, 86 Bankr. 625, 630-31 (Bankr. D.S.D. 1988); *Charterhouse*, 84 Bankr. at 152; *In re Hayball Trucking, Inc.*, 67 Bankr. 681, 682 (Bankr. E.D. Mich. 1986).

86. *Novak*, 86 Bankr. at 631. As yet, neither Montana nor the 9th Circuit has decided on an approach.

C. Procedure for Chapter 11 Modification Motions

Regardless of which view of "substantial consummation" a court takes, the party seeking modification must conform to certain formalities before the court will revise a plan. If the contemplated modifications will materially alter a confirmed plan, the party proposing the modification must circulate a disclosure statement explaining the changes and solicit acceptances from affected parties.⁸⁷ The Bankruptcy Code also requires notice and hearing before a court may grant a postconfirmation modification under Chapter 11. A court-approved modification will violate an unsecured creditor's due process rights unless that creditor receives notice of the modification motion.⁸⁸

D. Postconfirmation Modifications Under Chapter 12

Chapter 12 allows greater flexibility in postconfirmation modifications than Chapter 11. Section 1229 of Chapter 12 provides that the debtor, the trustee, or the holder of an allowed unsecured claim may request modification for three reasons to:

- 1) increase or reduce the amount of payments on claims of a particular class provided for by the plan;
- 2) extend or reduce the time for such payments; or
- 3) alter the amount of the distribution to a creditor whose claim is provided for by the plan to the extent necessary to take account of any payment of such claim other than under the plan.⁸⁹

Chapter 12, like Chapter 11, requires notice and hearing before a bankruptcy court may approve a postconfirmation modification.⁹⁰ Moreover, the party moving for Chapter 12 modification must demonstrate that the proposed alterations meet several threshold requirements.⁹¹ These threshold requirements provide a creditor with grounds for objecting to a debtor's postconfirmation modification.⁹²

87. *Andrew v. Coopersmith (In re Downtown Inv. Club III)*, 89 Bankr. 59, 65 (Bankr. 9th Cir. 1988); *In re Mount Vernon Plaza Community Urban Redevelopment Corp. I*, 79 Bankr. 305, 306 (Bankr. S.D. Ohio 1987).

88. *Andrew*, 89 Bankr. at 63. Of course, general due process requirements apply to all bankruptcy court judgments and orders. *Id.*

89. 11 U.S.C. § 1229(a) (1982 & Supp. V 1987).

90. 11 U.S.C. § 1229(b)(2) (1982 & Supp. V 1987).

91. 11 U.S.C. § 1222(a), (c) (1982 & Supp. V 1987) set forth the fundamental requirements. These sections contain mandatory terms for any plan, as well as allowable provisions concerning: classes of creditors, modifications of secured and unsecured claimant's rights, defaults, executory contracts and unexpired leases, and sale or distribution and vesting of estate property. 11 U.S.C. § 1223(c) states that a secured creditor is deemed to have accepted or rejected the modified plan (depending upon whether such creditor accepted or rejected the original plan). However, the foregoing is not applicable if the modification alters the secured creditor's rights as set forth in the original plan and the secured creditor changes its previous acceptance or rejection. *See, e.g., In re Dittmer*, 82 Bankr. 1019 (Bankr. D.N.D. 1988).

92. For example, a Chapter 12 modification cannot extend payments of unsecured

In addition to these requirements, any plan changes offered must be feasible for the debtor's compliance.⁹³ If the proposed modifications are not feasible, the court should deny the debtor's motion. For example, the Bankruptcy Court for the District of Montana recently applied this feasibility requirement to a reorganized debtor's farming operation.⁹⁴ The bankruptcy court found that the debtor could not substantiate its ability to make future payments, and had defaulted only six weeks after confirmation. The court thus denied modification as not feasible.⁹⁵

E. Considerations for Both Chapter 11 and Chapter 12 Modifications

Modification under either Chapter 11 or 12 is not warranted when the parties have foreseen and addressed the reason given for the default and subsequent proposed alteration in the confirmed plan. Thus, a creditor may argue that a debtor foresaw default if the confirmed plan contained a "drop dead" or other similar clause. An Indiana bankruptcy court recently held that "where a confirmed plan specifically provides that a secured creditor shall be relieved of the automatic stay in the event of default, the debtor may not modify the plan, in order to avoid the consequences of that default, over the objection of the affected creditor."⁹⁶ However, even if a confirmed plan contains provisions addressing virtually every possibility for prevention of a postconfirmation modification, a court may still discharge a Chapter 12 debtor because of hardship.

V. HARDSHIP DISCHARGES IN CHAPTER 12

The hardship discharge is unavailable in Chapter 11 bankruptcy proceedings, and thus becomes a factor only in farm and ranch reorganizations under Chapter 12.⁹⁷ A bankruptcy court may discharge a Chapter 12 debtor for hardship even when the creditors have not received full repayment. Further, a hardship discharge has the same effect as a full compliance discharge. Under section 1228(b) of Chapter 12, to issue a hardship discharge, the court must find that:

- (1) the debtor's failure to complete such payments is due to circumstances for which the debtor should not justly be held accountable;
- (2) the value, as of the effective date of the plan, of property actually distributed under the plan on account of each allowed unsecured claim is

claims beyond a three year term. 11 U.S.C. 1229(c) (1982 & Supp. V 1987). However, the bankruptcy court may allow a five year repayment term if the movant shows cause. *Id.* A modification plan may allow repayment of secured claims beyond five years. 11 U.S.C. 1222(b)(9) (1982 & Supp. V 1987); see also *In re Hart*, 90 Bankr. 150, 153 (Bankr. E.D.N.C. 1988).

93. 11 U.S.C. § 1225(a)(6) (1982 & Supp. V 1987).

94. *In re Paul Borg*, No. 87-40134, slip op. at 2 (Bankr. D. Mont. Dec. 14, 1988).

95. *Id.* The bankruptcy court also noted that the debtor had failed to notify the court of any payment difficulties before defaulting. *Id.*

96. *In re Grogg Farms, Inc.*, 91 Bankr. 482, 485 (Bankr. N.D. Ind. 1988).

97. 11 U.S.C. § 1228(b) (1982 & Supp. V 1987).

not less than the amount that would have been paid on such claim if the estate of the debtor had been liquidated under chapter 7 of this title on such date; and

(3) modification of the plan under section 1229 of this title is not practicable.⁹⁸

The debtor must meet all three conditions before the bankruptcy court will allow a hardship discharge.⁹⁹ In most situations, a debtor can more easily obtain a modification than a hardship discharge.

As yet no Montana Chapter 12 hardship cases have been reported. However, the Bankruptcy Court for the District of Montana recently granted a hardship discharge in an analogous Chapter 13 case.¹⁰⁰ In *In re Lenneman*, the debtor made ten timely payments under the reorganization plan.¹⁰¹ The debtor then contracted a debilitating disease with no prognosis for recovery.¹⁰² The court held that the debtor satisfied the first hardship requirement because his default was beyond his control.¹⁰³ Also, because the debtor had already distributed more property under the plan on each unsecured claim than those creditors would have received in liquidation, he fulfilled the second condition for a hardship discharge.¹⁰⁴ Finally, the debtor satisfied the third condition because his medical prognosis made postconfirmation modification impractical.¹⁰⁵ Having found all three elements satisfied, the court granted the debtor's hardship discharge.¹⁰⁶ Similar circumstances in a Chapter 12 bankruptcy should also support a hardship discharge.

Although Chapter 12 hardship discharges are rare, creditors should be aware of their existence. Because hardship situations present the debtor with almost impossible burdens of repayment, no real method exists to protect the creditor. Unfortunately it is impossible for creditors' counsel to plan for such discharges.

CONCLUSION

Although a debtor's bankruptcy under Chapters 11 and 12 presents many different problems for creditors, some preventive measures are available. A creditor should carefully protect its claim against codebtors and guarantors during the pendency of the bankruptcy case. During nego-

98. *Id.* The last condition of impracticability of modification will occur if the secured creditors refuse an otherwise acceptable modification or if some other impediment frustrates a modification. See 11 U.S.C. §§ 1325(a)(5)(A), 1329(b)(1) (1982), and 5 COLLIER ON BANKRUPTCY, ¶ 1328.01[2][b][iii] (L. King ed. 15th ed. 1979 & Supp. 1988).

99. *In re Lenneman*, 6 Mont. Bankr. Rep. 366, 367 (Bankr. D. Mont. Nov. 15, 1988); *In re Lee*, 71 Bankr. 833, 839 (Bankr. N.D. Ga. 1987).

100. *Lenneman*, 6 Mont. Bankr. Rep. at 366.

101. *Id.* at 366.

102. *Id.*

103. *Id.* at 368; 11 U.S.C. § 1228(b)(1) (1982 & Supp. IV 1986).

104. *Lenneman*, 6 Mont. Bankr. Rep. at 368.

105. *Id.*

106. *Id.*

tiation of a reorganization plan, the creditor should include provisions which protect the creditor's rights should the court dismiss the case or should a debtor attempt a postconfirmation modification. Of course, a creditor cannot eliminate the possibility of a Chapter 12 debtor's hardship discharge, but that contingency will rarely arise. Under all other circumstances, the creditor can best prepare for problems in a debtor's bankruptcy through planning, vigilance and timely action.